70-305

No. ~~1850~~

In the Supreme Court of the United States

OCTOBER TERM, 1970

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

FIRST SECURITY BANK OF UTAH, N.A., ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

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INDEX

CITATIONS

427-821—71——1

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v.

FIRST SECURITY BANK OF UTAH, N.A., ET AL.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgments of the United States Court of Appeals for the Tenth Circuit in this case.

OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (Appendix A, *infra*, pp. 17–35) are not reported. The opinion of the court of appeals (Appendix B, *infra*, pp. 37–50), reversing the Tax Court, is reported at 436 F. 2d 1192.

JURISDICTION

The judgments of the court of appeals were entered on January 21, 1971 (Appendix C, *infra*, pp. 51–52). By

order dated April 12, 1971, Mr. Justice White extended the time for filing a petition for a writ of certiorari to and including June 20, 1971. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, pursuant to Section 482 of the Internal Revenue Code, the Commissioner properly allocated to the respondent national banks the commission portion of the credit life insurance premiums paid by their borrowers in connection with loans, where respondents offered the life insurance to their borrowers ultimately on behalf of a life insurance company under common ownership and control with respondents.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 61 and 482 of the Internal Revenue Code of 1954, of Section 1.482-1 of the Treasury Regulations on Income Tax (1954 Code), and of Sections 5202 and 5239 of the Revised Statutes are set forth in Appendix D, *infra*, pp. 53-57.

STATEMENT

Respondents, First Security Bank of Utah, N.A., and First Security Bank of Idaho, N.A., are wholly-owned subsidiaries of First Security Corporation ("Holding Company"), a publicly owned bank holding company. Since 1948, respondents have offered to their borrowers credit life, health and accident insurance which discharges the debt if a borrower dies or becomes incapacitated during the term of his loan. (Appendix A, *infra*, pp. 18-22.)

From 1948 to April, 1954, the credit life insurance offered by respondents was written by two independent insurance companies. Both companies paid commissions ranging from 40 to 55 percent of the premiums collected to Ed D. Smith & Sons ("Smith"), a wholly-owned subsidiary of Holding Company engaged in the business of selling life and casualty insurance. (Appendix A, *infra*, pp. 20–22.)

Late in 1953, American National Life Insurance Company of Galveston, Texas ("American National") recommended a new plan to Holding Company. Under American National's plan, Holding Company would create a life insurance subsidiary, and American National would write the credit life insurance to be offered by respondents, and then reinsure all of the risk under those policies with Holding Company's life insurance subsidiary. In its initial years, the subsidiary would utilize American National's actuarial, accounting and other operating services on a fee basis. (Appendix A, *infra*, pp. 22–23.)

Holding Company adopted American National's plan and in June, 1954, formed a wholly-owned life insurance company, First Security Life Insurance Company of Texas ("Security Life"). For a fee of approximately 15 percent of the insurance premiums, American National, from 1954 through 1959, provided operating services to Security Life as planned, maintained Security Life's books and records, and computed its required reserves. Security Life received the balance of the premium dollar for the assumption of all of the risk under the insurance policies. (Appendix A, *infra*, pp. 20, 24–25.)

Security Life's sole source of business income was reinsurance premiums, and its reinsurance business was very profitable. By the end of 1954, Security Life was reinsuring $6.5 million of credit life insurance. By the end of 1959, Security Life was reinsuring $41.3 million of credit life insurance. Security Life was able to retain after all expenses—including American National's fee—52.5 percent of the total premiums. Its expenses, in addition to that fee, consisted primarily of bank charges, taxes and claim settlement expenses. Security Life's profit for the five-year period was more than $1 million. (Appendix A, *infra*, pp. 26–28.)

Respondents had numerous banking offices and maintained a routine procedure for offering credit life insurance to their borrowers. A loan officer explained the availability and function of credit life insurance to a customer and, if the customer desired the insurance, the loan officer gave him the necessary application forms. Upon receipt of the executed application, respondents' personnel completed a certificate of insurance, and either collected the premium from the customer or added it to his loan. Respondents' employees then forwarded the completed forms and premiums to First Security Company ("Management Company"), another Holding Company subsidiary which provided management services for the group. Management Company made records of insurance purchased and forwarded the forms and premiums to American National. Management Company also performed the necessary paper work when claims were filed under the policies. The cost to respondents of

processing the credit life insurance purchased by their borrowers from 1955 through 1959 was $8,929 and $9,826, respectively. The cost to Management Company of processing the insurance during the same period was $10,150. (Appendix A, *infra*, pp. 19, 21, 25–26.)

Both before and after the organization of Security Life in 1954, respondents offered credit life insurance to customers at the uniform rate of $1 per $100 of coverage per year on a decreasing term basis. This was the rate commonly charged in the credit life insurance industry. (Appendix A, *infra*, p. 26.)

Sections 5202 and 5239 of the Revised Statutes (Appendix D, *infra*, pp. 55–57) apparently prohibit national banks, under threat of criminal sanctions, from acting as insurance agents in places having a population of more than 5,000. From the time respondents began offering credit life insurance to their customers in 1948, their officers and those of Holding Company believed that it would be contrary to federal banking law for respondents to receive income resulting from their customers' purchases of credit life insurance. Accordingly, respondents have never received commissions or reinsurance premiums resulting from such purchases; rather, the commissions and reinsurance premiums have always been paid to corporations under common ownership with respondents. Specifically, from 1948 to April, 1954, the commissions were paid to Smith, and thereafter the reinsurance premiums were paid to Security Life. (Appendix A, *infra*, pp. 22, 24, 27, 29.)

Section 482 of the Internal Revenue Code (Appendix D, *infra*, p. 53) empowers the Commissioner to

allocate income among "two or more organizations, trades, or businesses * * * owned or controlled directly or indirectly by the same interests * * * if he determines that such * * * allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses." Acting under this provision, the Commissioner allocated 40 percent of the premium income to respondents for the period January 1, 1955 to December 31, 1959, and determined deficiencies accordingly. This allocation was to compensate respondents for selling and processing the credit life insurance and thereby to reflect their income clearly. For protective purposes, the Commissioner alternatively asserted deficiencies against Management Company by means of a similar allocation of premium income. Both respondents and Management Company sought redeterminations of the deficiencies in the Tax Court.[1] (Appendix A, *infra*, pp. 29–31.)

That court held that the case was controlled by its reviewed decision favorable to the government (two judges dissenting) in *Local Finance Corp.* v. *Commissioner,* 48 T.C. 773, affirmed, 407 F. 2d 629 (C.A. 7), certiorari denied, 396 U.S. 956, and sustained the Commissioner's determination that 40 percent of the premium income was allocable to respondents. It accordingly did not reach the Commissioner's alternative allocation. (Appendix A, *infra,* pp. 31–32, 34–35.) Respondents appealed, and the Commissioner took a pro-

[1] The Tax Court's jurisdiction to redetermine the deficiencies rested on Section 6214(a) of the Internal Revenue Code.

tective cross-appeal for review of the decision favorable to Management Company. The court of appeals reversed the decisions of the Tax Court against respondents, and also reversed the decision of the Tax Court for Management Company. It remanded the case for further consideration of the Commissioner's alternative allocation. (Appendix B, *infra,* p. 50.)

REASONS FOR GRANTING THE WRIT

1. The decisions below is in conflict with the decision of the Seventh Circuit in *Local Finance Corp.* v. *Commissioner,* 407 F. 2d 629, certiorari denied, 396 U.S. 956. The court below acknowledged the conflict, observing (Appendix B, *infra,* p. 46) that "Local Finance presents a fact situation quite comparable to that confronting us", and stated (Appendix B, *infra,* p. 50) that "[t]o the extent that this opinion is inconsistent with that in Local Finance we respectfully disagree with that decision." These conflicting decisions have created uncertainty and inequity in the application of Section 482 of the Code to lending institutions under common ownership and control with so-called "captive insurance companies."

There are no significant factual differences between *Local Finance* and this case. As the Tax Court pointed out (Appendix A, *infra,* p. 31), the facts of the two cases "[i]n all essential respects * * * are the same * * *." The critical facts are that in both cases lending institutions, performing virtually the same services, solicited insurance business for a commonly controlled insurance company, and reported none of the income resulting from the insurance activities as

their own.[2] In both cases, controlled corporate groups sought to achieve considerable tax savings by having the commission element of the insurance premiums included in the income of their life insurance subsidiaries,[3] which are subject to a lower effective tax rate[4] than their other subsidiaries. The only distinction between the cases is that the lending institutions in *Local Finance* were prohibited from acting as insurance agents by Indiana law, whereas here the source of the alleged proscription is federal law. This is a distinction without a difference, as respondents conceded below (Appendix B, *infra*, p. 45).

2. The arrangements typified by the instant case and by *Local Finance* are, moreover, common to the lending business, because of the natural relationship be-

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[2] Even the premiums charged in the two cases were the same. The Tax Court (48 T.C. at 777, 786) and the Seventh Circuit (407 F. 2d at 631) in *Local Finance*, and the Court of Claims in *Alinco Life Ins. Co.* v. *United States*, 373 F. 2d 336, 337–338, all have recognized that the standard $1 per $100 premium rate is sufficient to allow insurers to pay commissions or acquisition costs.

[3] Since the Commissioner's allocation was to compensate respondents for selling and processing insurance, the fact that they had no underwriting risk, relied upon by the court of appeals (Appendix B, *infra*, p. 49), is irrelevant. What is relevant is that here, as in *Local Finance* (407 F. 2d at 633), the lending institutions "performed those minimal [but crucial] services which were the *sine qua non* of the insurance business."

[4] All of the years involved in *Local Finance* were subject to the provisions of the Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112. Here, the years 1955–1957 are governed by the Life Insurance Company Tax Act of 1955, c. 83, 70 Stat. 36. The later years are subject to the provisions of the 1959 Act, which, as amended, remain in force today. See Sections 801–820 of the Code. Under both acts, life insurance companies are accorded preferential tax treatment.

tween that business and the credit life insurance business. Indeed, when Congress enacted the Life Insurance Company Tax Act of 1955, c. 83, 70 Stat. 36, it recognized this relationship and the potential tax abuses, and specifically contemplated that Section 482 would be used in captive insurance company cases.[5] Both committee reports on the Act provide (H. Rep. No. 1098, 84th Cong., 1st Sess., p. 7; S. Rep. No. 1571, 84th Cong., 2d Sess., p. 8):

> There is a potential abuse situation in the case of the so-called captive insurance companies. It may be possible for a finance company, for example, to establish a subsidiary life insurance company that will issue life insurance policies in connection with the business of the parent. If the subsidiary charges excessive premium on this business, a portion of the income of the parent company can be diverted to the life insurance company. It is believed that section 482 of the Internal Revenue Code of 1954 (relating to allocation of income and deductions among related taxpayers) provides the Secretary of the Treasury ample regulative authority to deal with this problem.

The congressional concern has proved well-founded.[6]

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[5] Since the preferential treatment of life insurance companies continues under the 1959 Act (see n. 4, supra), the problem caused by a diversion of income from a lender to a related insurer persists as illustrated by the instant case and by *Local Finance*.

[6] Respondents contended below, in reliance on the tax-writing committees' reference to "excessive premium," that Congress was not concerned with cases such as this one, where borrowers paid the industry-wide premium rate for credit insurance (see n. 2, *supra*), but only with situations in which borrowers paid more

We are advised by the Internal Revenue Service that, in addition to the instant case, there are presently pending, judicially and administratively, substantially identical cases involving 22 groups of related taxpayers[7] in which the net tax in dispute is estimated to exceed $67 million.[8] The largest of these groups consists of some 1,000 related taxpayers. Moreover, after the decision in *Local Finance* and before the decision below, the Internal Revenue Service settled cases, strictly on the basis of the *Local Finance* holding, with seven groups of related taxpayers which agreed to pay approximately $10 million of net tax.[9] A substantial number of additional cases is certain to

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than the standard rate. This reading of the legislative history is incorrect. So long as a lender is fairly compensated for its services, there would be no diversion of income to the related insurer, and therefore no occasion to invoke Section 482, even if the borrower pays more than the going rate. There is a diversion, and Section 482 would come into play, however, whether the borrower pays the going or a higher rate, if the insurer fails to compensate the lender for its services. In such a situation, the insurer has charged an "excessive premium," and it is in this sense that Congress used the quoted term.

[7] One of these 22 groups is the First Security group (including respondents), which has docketed cases pending for later years.

[8] We refer to the "net tax in dispute" to make it clear that the revenue estimate is based only on the Commissioner's proposed primary allocations and is not inflated by the inclusion of the alternative allocations made to protect the revenues if the primary allocations are not sustained. Further, the estimate has been adjusted downward to reflect the fact that the deficiencies arising from the Commissioner's primary allocations would be partially offset by reductions in the income of the captive insurance companies.

[9] Four of these seven groups are among the 22 groups which have cases pending for later years.

arise in view of the obvious advantages accruing to an affiliated group of corporations which engages in both lending and credit life insurance activities. Until this Court provides a definitive solution, responsible government officials and private counsel will, as a practical matter, be unable to advise their respective clients to resolve problems such as those raised here, short of litigation. And, unless the Court resolves the present conflict in the circuits, lending institutions and captive insurance companies in different parts of the nation will be taxed differently even though they are involved in virtually identical commercial undertakings.

There is, to be sure, a substantial factual element in cases of this type. Factual differences between cases might justify a particular percentage allocation in one case and a higher or lower percentage allocation in another. But the court below did not hold that the Commissioner should have allocated some percentage less than 40 percent of the premiums to respondents, but rather that he was without power to make any allocation at all. As the court put it (Appendix B, *infra*, p. 50), the Commissioner's Section 482 allocations were "arbitrary and capricious and inconsonant with the basic concepts of federal income taxation." Furthermore, where as here and in *Local Finance*, the underlying facts are not in dispute, the differences in result cannot be ascribed to the facts, but must be attributed to differing interpretations of Section 482 by the Tenth and Seventh Circuits. The issue posed thus goes to the meaning and scope of that provision, and is one that is appropriate for resolution by this Court.

3. Although Section 482 was first enacted as Section 45 of the Revenue Act of 1928, c. 852, 45 Stat. 791, 806, it has not previously been considered by the Court on the merits. The statute was designed "to prevent evasion [of taxes by related taxpayers] (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order clearly to reflect their true tax liability." H. Rep. No. 2, 70th Cong., 1st Sess., pp. 16–17. It is settled that in applying the provision, the applicable standard is "that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Treasury Regulations on Income Tax (1954 Code), Section 1.482–1(b)(1) (Appendix D, *infra*, pp. 53–55); *Oil Base Inc.* v. *Commissioner*, 362 F. 2d 212, 214 (C.A. 9), certiorari denied, 385 U.S. 928.

While purporting to adhere to this standard (Appendix B, *infra*, pp. 43–46, 49–50), the court below applied Section 482 erroneously and in a manner which we believe seriously threatens to impair its continuing effectiveness. Respondents, the court said, could not be taxed on any part of the commissions or insurance premiums because they did not *receive* them (Appendix B, *infra*, pp. 45–46, 49–50), or *earn* them (*id.*, p. 50), but only *generated* the business or income (*id.*, pp. 46–50). All of this misconstrues Section 482.

Application of that section is, of course, not dependent on the receipt of income. See *Asiatic Petroleum Co.* v. *Commissioner*, 79 F. 2d 234, 236 (C.A. 2), certiorari denied, 296 U.S. 645. Indeed, an allocation of gross income thereunder presupposes that the in-

come was not *received* by the taxpayer which has so arranged its affairs as to divert the income to another.

Nor is the question whether respondents "earned" the income relevant under Section 482. See *Rubin* v. *Commissioner*, 429 F. 2d 650, 653 (C.A. 2). That is the issue under Section 61 of the Code (Appendix D, *infra*, p. 53), which provides, to the extent pertinent here, that "gross income means all income from whatever source derived, including * * * [c]ompensation for services, including fees, commissions, and similar items * * *." To hold that the same standard applies under Section 482 would make that provision redundant, at least insofar as allocations of gross income are concerned.

It is unclear precisely what the court of appeals meant when it said that respondents only "generated" the business or income. Use of this term, however, cannot conceal that respondents' income was less than it would have been had they been dealing with an unrelated insurance company during the years in issue. From 1948 to April, 1954, respondents performed all of the services incident to the sale of credit life insurance to their borrowers, and during that period two independent insurers paid commissions of 40 to 55 percent of the premiums collected to Smith, an affiliate of respondents. Thereafter respondents performed the same services for Security Life, a related insurer, but did not charge Security Life for these services. These facts alone are sufficient to show that respondents did not deal with Security Life as they

had dealt with unrelated insurers, and that an allocation is necessary to reflect their income clearly.[10]

The apparent prohibitions of federal banking law cannot alter this result. Respondents interpret Sections 5202 and 5239 of the Revised Statutes as prohibiting them from receiving income from acting as life insurance agents, but not from offering life insurance at the industry-wide premium rate. Their principal argument, apparently accepted by the court of appeals (Appendix B, *infra*, pp. 44–46, 49–50), is that the Commissioner's allocation is unauthorized because Section 482 is limited to allocations of income which may be lawfully received. But Section 482 grants the Commissioner authority to allocate income and deductions between related organizations not only when this "is necessary [in order] to prevent evasion of taxes" but also when necessary "clearly to reflect the income of any such organizations." *Central Cuba Sugar Co.* v. *Commissioner,* 198 F. 2d 214, 215 (C.A. 2), certiorari

[10] The fact, relied on by the court of appeals (Appendix B, *infra*, pp. 45–46, 49, 50), that even before Security Life's organization in 1954, no portion of the insurance premiums was paid to respondents, is no more relevant than the same fact in later years. The critical point is that when respondents dealt with independent insurers, those insurers paid a commission, whereas Security Life did not. That the commissions were paid to Smith, which was in no way involved in the sales of credit life insurance here in dispute, does not help respondents' case, but rather emphasizes Holding Company's power to designate which of its subsidiaries would receive the commissions. And even Holding Company did not consider the fact of receipt dispositive of the income tax consequences, for although it selected Smith to receive the commissions, it nevertheless had Management Company report them for tax purposes.

denied, 344 U.S. 874. Thus, even if the business arrangements adopted were required to, and did, satisfy federal banking law, the question remains whether respondents' income was clearly reflected. The answer to this question turns on federal tax law, not on federal banking law (cf. *Nat'l Securities Corp.* v. *Commissioner,* 137 F. 2d 600, 602 (C.A. 3), certiorari denied, 320 U.S. 794), and under the former, illegal gains, like legal gains, are taxable whether received or not. Compare *James* v. *United States,* 366 U.S. 213, with *Bailey* v. *Commissioner,* 52 T.C. 115, 119, affirmed *per curiam,* 420 F. 2d 777 (C.A. 5).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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JUNE 1971.

427-821—71——3

[illegible] U.S. [illegible]. Thus, even if the business ar- [illegible] required [illegible] and [illegible], namely [illegible] law, the question remains whether [illegible]. The answer [illegible] Federal tax law, not on [illegible] [illegible]

[illegible]

Respectfully submitted.

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APPENDIX A

Tax Court of the United States

T.C. Memo. 1967–256

First Security Bank of Utah, N.A., et al.,[1] petitioners *v.* Commissioner of Internal Revenue, respondent

Docket Nos. 1190–63, 1191–63, 1216–63

Filed December 27, 1967

MEMORANDUM FINDINGS OF FACT AND OPINION

Fay, *Judge:* Respondent determined deficiencies in the petitioners' income taxes as follows:

Docket No.	Petitioner	Taxable year	Deficiency
1190–63	First Security Bank of Utah, N.A.	1954	$68,250.00
		1955	28,775.81
		1956	54,526.56
		1957	77,862.91
		1958	150,371.46
		1959	109,166.60
1191–63	First Security Company	1956	95,997.48
		1957	128,400.83
		1958	262,124.10
		1959	179,550.34
1216–63	First Security Bank of Idaho, N.A.	1954	68,250.00
		1955	26,139.85
		1957	160,292.86
		1958	102,752.67

During the trial, respondent stated that he would not pursue one of the issues raised in the pleadings.

[1] Proceedings of the following petitioners are consolidated herewith: First Security Company, Docket No. 1191–63, and First Security Bank of Idaho, N.A., Docket No. 1216–63.

We therefore conclude that he has abandoned it. The issues remaining for decision are:

(1) Whether respondent erred in allocating, pursuant to sections 61 and 482,[2] to petitioners First Security Bank of Utah, N.A., and First Security Bank of Idaho, N.A., a portion of the income which First Security Life Insurance Company of Texas received from January 1, 1955, to December 31, 1959, for reinsuring credit life, health, and accident insurance,[3] or in the alternative, whether he erred in allocating, pursuant to said sections, to petitioner First Security Company a portion of said income which First Security Life Insurance Company of Texas received from January 1, 1956, to December 31, 1959; and

(2) whether respondent properly put section 482 in issue and, if so, whether he should have the burden of proof.

FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulation of facts, together with the exhibits attached thereto, is incorporated herein by this reference.

Petitioner First Security Bank of Utah, N.A. (hereinafter referred to as Utah Bank), is a national bank incorporated in 1882. It filed its Federal income tax returns for the taxable years involved herein on a calendar year basis with the district director of internal revenue, Salt Lake City, Utah. Its principal

[2] All statutory references are to the Internal Revenue Code of 1954, unless otherwise specified.

[3] The statutory notice received by petitioner First Security Bank of Idaho, N.A., contained adjustments to certain net operating loss carrybacks. Because of these adjustments, this Court has jurisdiction under section 6214(b) to determine the correctness of respondent's allocations to this petitioner for the years 1956 and 1959.

place of business was Salt Lake City, Utah, when it filed its petition in this case.

Petitioner First Security Bank of Idaho, N.A. (hereinafter referred to as Idaho Bank), is a national bank, incorporated as such in 1941 after operating since 1865 as a state bank. It filed its Federal income tax returns for the taxable years involved herein on a calendar year basis with the district director of internal revenue, Boise, Idaho. Its principal place of business was Boise, Idaho, when it filed its petition in this case.

Petitioner First Security Company (hereinafter referred to as Management Company) is a corporation organized under the laws of Utah in 1929. It filed its Federal income tax returns for the taxable years involved herein on a calendar year basis with the district director of internal revenue, Salt Lake City, Utah. Its principal place of business was Salt Lake City, Utah, when it filed its petition in this case.

Petitioners are wholly-owned subsidiaries of the First Security Corporation (hereinafter referred to as Holding Company). It is the oldest bank holding company in existence. It is under the supervision and control of, and is regularly examined by, the Federal Reserve System. It is qualified under and subject to the Bank Holding Company Act, 12 U.S.C. sections 1841 *et seq.* From 1954 through September 15, 1959, Holding Company had approximately 1,044,963 shares of common voting stock outstanding and from 2,000 to 3,000 shareholders residing in various states and foreign countries.

Holding Company has had a policy of business expansion and acquisition throughout its existence. The banking offices of its subsidiaries extend from the

Canadian border to the Arizona border. Moreover, it has entered into diversified enterprises other than banking.

From 1954 to September 15, 1959, Holding Company had the following wholly-owned subsidiaries, in addition to petitioners:

(a) The First Security Life Insurance Company of Texas (hereinafter referred to as Security Life), a corporation organized and licensed as an insurance company pursuant to the laws of Texas.

(b) Ed. D. Smith and Sons (hereinafter referred to as Smith), a Utah corporation. It had approximately twenty employees and sold life and casualty insurance. It had a yearly premium volume of approximately $800,000.

(c) First Security Insurance Agency, Inc. (hereinafter referred to as Agency), an Idaho corporation. It sold insurance and had a yearly premium volume of about $175,000.

(d) Western Investment Corporation, an Idaho corporation holding various assets.

(e) First Security State Bank, a Utah State bank.

(f) First Security Bank, a Wyoming State bank.

(g) Security Savings and Loan Association, a Utah State savings and loan association; and

(h) First Security Savings and Loan Association, an Idaho State savings and loan association.

On September 15, 1959, Holding Company underwent a reorganization pursuant to the Bank Holding Company Act, *supra.* The banking subsidiaries, including the three petitioners herein, were placed in a newly-organized bank holding company. The shareholders of Holding Company received the stock of the new bank holding company. The nonbanking

subsidiaries, including Security Life, remained in the old holding company.[4]

Utah Bank and Idaho Bank have numerous banking offices. Both are subject to supervision, inspection, and control by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency and are regularly examined by them. The articles of incorporation of the banks limit them to the business of banking under the laws of the United States. Under the national banking laws, the members of the boards of directors of the banks are responsible for the proper operation of the banks. During the years in issue, Utah Bank had 141,000 to 192,000 depositors and $217,000,000 to $292,000,000 in deposits. During the same years, Idaho Bank had 113,000 to 131,000 depositors and $183,000,000 to $205,000,000 in deposits.

Management Company provides accounting and other management services to the other subsidiaries of Holding Company. Management Company is subject to control, supervision, and inspection by the Board of Governors of the Federal Reserve System and is regularly examined by it.

In 1948 Utah Bank and Idaho Bank began making available credit life, health, and accident insurance (hereinafter referred to as credit insurance)[5] to their customers. They did this for several reasons, including (1) to offer a service increasingly supplied by com-

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[4] Although the new holding company received the name of the old one—First Security Corporation—while the old one changed its name to First Security Investment Company, the term "Holding Company" will continue to refer to the pre-reorganization holding company.

[5] For a description of the credit insurance industry, see *Local Finance Corporation*, 48 T.C. 773 (1967), at 776 *et seq.*

peting financial institutions, (2) to obtain the benefits of the additional collateral which credit insurance provides by repaying loans upon the death, injury, or illness of the borrower, and (3) to provide an additional source of income—part of the premiums from the insurance—to Holding Company or its subsidiaries.

From 1948 through 1952, Credit Life Insurance Company of Springfield, Ohio, wrote the credit insurance which Utah Bank and Idaho Bank had available for their customers. Credit Life Insurance Company and Smith entered into agency agreements designating Smith as Credit Life's agent in writing the the insurance. Pursuant to the agreements, Credit Life paid commissions to Smith as follows:

Period	Amount of payment to Smith per agency agreement	Characterization of payment in agency agreement
9-24-48 through 6-1-50.	40 to 50 percent of net premiums collected, based on volume.	Commissions..
6-1-50 through 12-31-52.	55 percent of premiums	45 percent commission, 10 percent expense reimbursement.

From January 1, 1953, through April 1, 1954, American Bankers Life Assurance Company of Florida wrote the credit insurance which Utah Bank and Idaho Bank had available for their customers. American Bankers Life Assurance Company and Smith entered into an agency agreement designating Smith as American Bankers' agent in writing the insurance. Pursuant to the agreement, American Bankers paid commissions to Smith of 55 percent of the net premiums collected on life insurance and 50 percent of the net premiums collected on health and accident insurance.

Late in 1953, American National Insurance Company of Galveston, Texas (hereinafter referred to as

National),[6] approached Holding Company with a plan whereby National would write the credit insurance which Utah Bank and Idaho Bank made available to their customers. The plan called for Holding Company to create a life insurance subsidiary. The subsidiary's business would be to reinsure the risks of the credit insurance policies written by National for the customers of the two Banks. Profits from the business could be retained in the subsidiary for investment. In its initial years, the subsidiary would utilize National's established and experienced operating services—actuarial, accounting, etc.—on a fee basis. If the plan proved successful, the new insurance subsidiary could grow into a full-line, direct-writing insurance company.

Holding Company was one of many financial institutions which National approached with such a plan. During 1953 National concluded that lending institutions would soon begin to form their own life insurance companies to write the credit insurance which they made available to their customers. They based their conclusion upon the facts that writing credit insurance was proving to be a very profitable business and that there were considerable tax savings on premium income.[7] This potential move by lending institutions would ultimately deprive National and other independent insurance companies of their credit insurance business. To salvage what it could from the situation, National decided to encourage lending institutions to develop their own life insurance com-

[6] National is a leading nationwide insurance company. It is independent of and unrelated to Holding Company and its subsidiaries.

[7] The Life Insurance Company Income Tax Act of 1959 in large part eliminated the tax savings. See generally Mertens, sec. 44A.01 *et seq.*

panies by utilizing the operating services which National had developed for writing credit insurance. By charging a fee for the services, National would recoup something from its investment in the credit insurance business.

Holding Company decided to adopt National's plan. It did so for numerous reasons, including its policy of business expansion. To implement the decision, Holding Company incorporated Security Life in June 1954. Security Life was incorporated under the laws of Texas and approved by the Texas State Board of Insurance Commissioners. It had an initial capital of $25,000[8] and an initial paid-in surplus of $12,500.[9]

National began writing credit insurance for the customers of Utah Bank and Idaho Bank in April 1954. The insurance was reinsured with Security Life under contracts called reinsurance treaties. Under the treaties National received approximately 15 percent of the premium dollar for its managerial services and Security Life received the balance of the premium dollar for its assumption of 100 percent of the risk under the insurance policies.[10]

From April 1954 through 1959, National maintained Security Life's books and records and computed its required reserves. By purchasing the services of National, Holding Company effected considerable savings over what would have been the case

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[8] Security Life's capital was increased to $100,000 in 1956 through a $75,000 stock dividend.

[9] This was an unusually low capitalization with which to begin an insurance company. In 1954 Texas had low minimum capitalization requirements for incorporating insurance companies.

[10] The maximum on one life under the policies which Security Life reinsured was $5,000.

had it attempted to launch a full-line, direct-writing company from the outset. It is a common practice to begin an insurance company by reinsuring risks and, if successful, grow into a full-line, direct-writing company.[11] There is no basic actuarial or business difference between an insurance company which reinsures and a direct-writing company.

Utah Bank and Idaho Bank had a routine procedure for making credit insurance available to customers. A loan officer explained the availability and function of credit insurance to a customer. If the customer desired the insurance, the loan officer gave him application forms. The customer then filled in the application. After examining the application, Bank personnel filled in a certificate of insurance and either collected the preimum from the customer or added it to his loan. As the final step, Bank personnel forwarded the completed forms to Management Company for further handling.

Utah Bank and Idaho Bank did not require customers to purchase credit insurance. During the years in issue, less than one-half of the Banks' installment loan customers elected to take insurance and less than 13 percent of the Banks' real estate loan customers elected to take insurance.

The cost to Utah Bank and Idaho Bank of processing the insurance was negligible. For the five years in issue, the total cost to Utah Bank was $8,929.30 and the total cost to Idaho Bank was $9,826.43.[12]

Management Company's role in processing the credit insurance was in the nature of bookkeeping. It had no contact with the public with respect to writing

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[11] Security Life never developed into a full-line, direct-writing company.

[12] These figures are derived from an extensive time-cost study prepared by an employee of Management Company.

credit insurance. It received the forms, duplicate certificates, and premiums from Utah Bank and Idaho Bank. It then made records of insurance purchased and forwarded premiums to National. It also did the paper work when claims had to be filed under the policies.

The cost to Management Company of processing the insurance was negligible. For the five years in issue, the total cost was $10,150.34.[13]

Idaho Bank, Utah Bank, and Management Company were not parties to the legal relationships and obligations of the insurance policies. National wrote the insurance and the Banks' customers were its policyholders. Under the terms of the policies, National was responsible for payment of claims. Under the reinsurance treaties, Security Life was obligated to reimburse National for claims it paid.

Other than group policies, there were no contracts, agency agreements, or other legal connections between National and Idaho Bank, Utah Bank, or the employees of both. There were no contracts, agency agreements, or other legal connections between National and Management Company or its employees.

From 1948 through 1959, the credit insurance which Idaho Bank and Utah Bank made available to their customers was priced at the uniform rate of $1 per $100 coverage per year on a decreasing term basis. This was the rate commonly charged in the industry. It was accepted by the insurance commissioners of the states involved herein—Utah, Idaho, and Texas.

During the years in issue, Security Life paid state and Federal taxes, used its own stationery, made deposits and withdrawals from bank accounts in its own name, and invested in its own name. Its sole source

[13] This figure is derived from the time-cost study described in footnote 12, *supra*.

of business income was reinsurance premiums. Its business expenses were primarily bank charges, taxes, and claims settlement expenses.

Security Life's credit insurance business was very profitable. Its yearly operations for the period 1955 through 1959 are reflected in the following table:

Yea	Net premium [1]	National's fee	Reinsurance premium received by Security Life	Claims and claims expenses	Net profit to Security Life
1955	$145,927.55	$24,765.65	$121,161.90	$45,340.38	$76,[illegible].52
1956	277,437.45	43,695.72	233,741.73	97,899.66	136,132.07
1957	367,612.62	55,590.64	312,021.98	114,014.49	198,007.49
1958 [2]	647,874.90	62,954.22	584,920.68	118,874.46	466,046.22
1959	477,389.43	71,608.43	405,781.00	149,948.92	255,832.08
Total	$1,916,241.95	$258,614.66	$1,657,627.29	$525,787.91	$1,131,839.38
Less closing Life Reserve, 12-31-59					110,806.00
Less general expense for period 1-1-55 through 12-31-55					16,339.00
Total profit					$1,004,694.38

[1] Gross premium less cancellations and adjustments.
[2] Includes 1958 reserve adjustment.

Security Life's operations for the years in issue are summarized in the following table in terms of percentages of total net premiums received.

Item:	*Percent of total net premiums received*
Fee paid to National	13.5
Claims paid	27.4
Life reserve on 12/31/59 and general expenses	6.6
Balance	52.5
Total	100.0

Security Life's balance sheets for the period January 1, 1955, through December 31, 1959, are summarized in the following table:

	1955	1956	1957	1958	1959
Assets	$161,370.52	$390,286.87	$648,586.43	$1,204,424.45	$1,050,220.71
Liabilities (including reserves)	13,076.98	22,295.00	30,277.60	271,479.06	197,687.00
Capital	25,000.00	100,000.00	100,000.00	100,000.00	100,000.00
Surplus:					
Paid-in	12,500.00	12,500.00	12,500.00	12,500.00	12,500.00
Unassigned		35,099.41			
Earned	110,793.54	220,392.46	505,808.83	820,445.39	[1] 740,033.71
	$161,370.52	$390,286.87	$648,586.43	$1,204,424.45	$1,050,220.71

[1] Security Life paid a dividend of $389,821.61 to Holding Company during 1959.

Although Security Life's business proved to be successful, there was no way to judge at the outset whether it would succeed. In relation to its capital structure, Security Life reinsured a large amount of risk. The following table shows the number of policies reinsured, the amount of risk it assumed, and the number of extra maximum claims which would have eliminated its surplus at the end of a year:

Year	Number of policies	Amount of risk at end of year	Number of extra maximum claims which would have eliminated surplus
1954	12,500	$6,488,000	3
1955	27,594	13,360,000	9
1956	34,388	21,105,000	28
1957	29,591	25,570,000	28
1958	32,155	30,761,000	50
1959	36,416	41,350,000	97

Furthermore, there were several aspects of Security Life's business which could have invited high mortality rates. Customers of the two Banks could obtain credit insurance without a health examination and there was no waiting period before the insurance

went into effect. In addition, Security Life was a relatively small insurance company and its policyholders lived in a relatively limited geographical area.

Since Utah Bank and Idaho Bank began making available credit insurance to their customers in 1948, the officers of Holding Company and of the two Banks have held the belief that it would be contrary to Federal banking law for the two Banks to receive income resulting from their customers' purchase of credit insurance. They based the belief on the advice of legal counsel. Pursuant to the belief, the two Banks have never received or attempted to receive commissions or reinsurance premiums resulting from their customers' purchase of credit insurance.

Petitioners Idaho Bank and Utah Bank reported no income from sales of credit insurance on their Federal income tax returns for the years 1955 through 1959. Petitioner Management Company reported no income from sales of credit insurance on its Federal income tax returns for the years 1956 through 1959.

In his statutory notices of deficiency, respondent allocated to petitioners Utah Bank and Idaho Bank the reinsurance premiums received by Security Life from 1955 through 1959. He also, alternatively, allocated to petitioner Management Company the reinsurance premiums received by Security Life from 1956 through 1959.[14] The pertinent explanatory material in each notice of deficiency is as follows:

> It is determined that the insurance premium[s] and/or commission income reported

[14] During the trial and on brief, respondent only urged the allocation of 40 percent of the net premiums which Security Life received from reinsuring credit insurance. He did not allocate any income which Security Life received for reinsuring risks on mortgage, twin-dollar, and borrow-by-check insurance, three types of insurance which Security Life reinsured in addition to what we refer to herein as credit insurance.

as income by the First Security Life Insurance Company of Texas, a corporation, the stock of which is owned by The First Security Corporation, the same corporation which owns your stock, should have been reported by you. Therefore, your taxable income is increased as indicated for each of the taxable years 1955 [1956] through 1959.

In a different case than the one at bar, respondent has asserted a deficiency against Security Life for the years 1955 through 1959. More than three years before the trial of the present case, Security Life filed a sworn protest with the district director of internal revenue, Salt Lake City, Utah, contesting the asserted deficiency. Counsel for petitioners herein prepared Security Life's protest. To explain the difference between Security Life's case and the case at bar, the protest contains the following language:

> The issues involved are not at all related; each turns on its own set of facts and its own section of the Internal Revenue Code. The issue involved in the bank cases is whether the banks were the true earners of the income, and hence taxable under Section 482. The issue in this case is whether the reserves were established and maintained on an actuarial basis as required by Section 801(a).

In the case at bar, respondent never filed any document prior to the pretrial conference formally notifying petitioners that he intended to rely on section 482. Two days prior to the trial herein, respondent filed a motion for a pretrial conference pursuant to Rule 28, Rules of Practice of the Tax Court. In the motion, respondent stated that he would rely on section 482 as well as section 61.

OPINION

The first issue is whether respondent has properly put section 482 in issue.

Petitioners argue that because respondent did not specifically mention section 482 in his notices of deficiency, and because he did not otherwise specifically and formally notify petitioners prior to the pretrial conference that he would rely on section 482, he is barred from relying on that section. Alternatively, petitioners argue that if we permit respondent to rely on section 482, he should bear the burden of proof because the determination with respect to the section 482 issue in the statutory notices does not contain sufficient legal and factual grounds.

We do not agree with either argument. Petitioner's counsel knew three years in advance of the trial that respondent would rely on section 482. Moreover, petitioners do not allege surprise or suggest that they were prejudiced in any way by respondent's alleged omissions. It is clear from the record that petitioners' counsel were well prepared with an extensive and thorough case on the section 482 issue. In view of these circumstances, the cases which petitioners cite on this point are distinguishable. We hold that respondent has properly put section 482 in issue and that petitioners have the burden of proof.

The second issue is whether respondent erred in allocating, pursuant to sections 61 and 482, either to Utah Bank and Idaho Bank or to Management Company 40 percent of the net premiums which Security Life received during the years in issue for reinsuring credit insurance.

In all essential respects, the facts of the case at bar are the same as those in *Local Finance Corporation,*

48 T.C. 773 (1967). Because of our decision in that case, most of petitioners' arguments on this issue are untenable. Petitioners do, however, make two arguments concerning the actuarial soundness of respondent's allocations which are not foreclosed by our earlier decision.[15]

Petitioners' main actuarial argument is based upon the testimony of their expert actuary. The crux of the testimony is the opinion contained in the following exchange:

> Q. What is your opinion?
> A. The size and nature of the risk assumed by this company [Security Life] in relationship to its capital structure required it to retain every dollar that it could possibly do so.
> Q. To stay on an actuarially sound basis?
> A. Yes.

Petitioners' actuary based his opinion upon the amount of risk which Security Life reinsured and upon factors in its insurance operation which might have invited high mortality rates.

Petitioners claim that their actuarial evidence demonstrates that Security Life would have been actuarially unsound if it had paid an insurance commission to the Banks equal to what respondent now allocates to them. It follows, petitioners argue, that respondent's allocation pursuant to sections 61 and 482 is unreasonable.

We do not agree. The central fact upon which petitioners' actuary based his testimony was Security Life's initial capital structure of $37,500. In the above-quoted passage he said that Security Life assumed great risk "in relationship to its capital structure." Respondent's actuary pointed out that Security Life's initial capitalization was unusually low for an insur-

[15] See *Local Finance Corporation*, *supra*, at 791.

ance company. Petitioners' actuary corroborated this with the following testimony:

> Now, within the life insurance industry there is a very much used rule of thumb for new life insurance companies that is to establish it with capital and surplus of approximately 100 times its maximum risk on one life.
>
> This is arbitrary and a rule of thumb, but it is also true that throughout the industry the amount that companies will retain on one life is closely in that neighborhood.

The maximum risk on one life under the policies reinsured by Security Life was $5,000. Using the formula suggested by petitioners' actuary, Security Life's initial capitalization should have been $500,000, not $37,500. If its initial capitalization had been $500,000 rather than $37,500, petitioners' actuarial evidence would be meaningless. The validity of the evidence, in other words, hinges upon the fact that Security Life began business as an undercapitalized insurance company. This evidence does not persuade us that respondent's allocation pursuant to sections 61 and 482 is unreasonable.

Petitioners make another actuarial argument based upon the fact that respondent, during trial and on brief, did not allocate to them Security Life's income from reinsuring risks on lines of insurance other than what we herein refer to as credit insurance. Petitioners contend that respondent ignored these lines because Security Life had a much higher claims experience with them than with credit insurance. Petitioners argue that this omission by respondent is a concession that a 40 percent allocation on the other lines of insurance would be unreasonable. They conclude that what is unreasonable for the other lines of insurance is also unreasonable for credit insurance.

We do not agree. Petitioners did not attempt to prove any business or actuarial similarities between Security Life's reinsurance of credit insurance and its reinsurance of other lines. It follows that we cannot draw inferences between the two lines. We do not decide what meaning, if any, attaches to the fact that respondent did not allocate Security Life's income from reinsuring the other lines of insurance.

Neither of petitioners' actuarial arguments persuades us that respondent's allocation pursuant to sections 61 and 482 is unreasonable. The arguments do not, therefore, distinguish the present case from *Local Finance Corporation, supra.* It follows that we must uphold as reasonable respondent's allocation of part of Security Life's income.

One problem remains—to which taxpayer should we allocate the income in question. Respondent, in his notices of deficiency, allocates the income either to Utah Bank and Idaho Bank or to Management Company.

Petitioners argue that the only taxpayers to which we can properly allocate the income are Smith and Agency, neither of which is a party herein. Their theory is based upon the facts that from 1948 through 1954 insurance commissions for the sale of credit insurance in the two Banks were payable to Smith and that during the years here in issue Smith and Agency held licenses to sell insurance. Because insurance commissions have never been payable to petitioners, and because none of the petitioners has ever held a license to sell insurance, they argue that it is logical to allocate the income to Smith and Agency, rather than to them.

We do not agree. Petitioners performed services with regard to the sale of credit insurance during the years in issue. Smith and Agency did not. Therefore, it is not proper to allocate the income to Smith and Agency. See concurring opinion in *Local Finance Corporation, supra,* at 797.

Among the petitioners, we allocate the income to Utah Bank and Idaho Bank. Our decision in *Local Finance Corporation* dictates this result.

Decisions will be entered under Rule 50.

APPENDIX B

United States Court of Appeals, Tenth Circuit

January Term, 1971

No. 611–69

FIRST SECURITY BANK OF UTAH, N.A., PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLEE

No. 612–69

FIRST SECURITY BANK OF IDAHO, N.A., PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLEE

No. 613–69

FIRST SECURITY COMPANY, PETITIONER-APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLANT

APPEALS FROM DECISIONS OF THE TAX COURT OF THE UNITED STATES

Before BREITENSTEIN and SETH, Circuit Judges, and TEMPLAR, District Judge.

BREITENSTEIN, Circuit Judge.

These consolidated appeals from the Tax Court relate to the allocation of income among taxpayers. No. 611–69 is an appeal by First Security Bank of Utah, N.A., (Utah Bank) from the decision that for the years 1955 to 1959 inclusive there is a deficiency in income taxes due from the taxpayer in the amount of $187,863.92. No. 612–69 is an appeal by First Security Bank of Idaho, N.A., (Idaho Bank) from the holding that for the tax years 1955, 1957, and 1958 there is a deficiency of $210,714.41. No. 613–69 is a protective appeal by the Commissioner of Internal Revenue from the decision that there are no deficiencies in the income taxes due from First Security Company (Management Company) for the years 1956 to 1959 inclusive. The Tax Court held that approximately 40% of credit insurance net premiums paid by borrowers from the two banks, and reported by another corporation, were allocable to income of the banks. Jurisdiction is conferred by 26 U.S.C. § 7482(a). Venue for the appeal of the Idaho Bank is in this court pursuant to a stipulation made under § 7482(b)(2). The findings of fact and opinion of the Tax Court are not officially reported but are found at 26 T.C.M. 1320.

The taxpayers are national banks. They and a Wyoming bank, Management Company, and certain nonbanking affiliates were until 1959 wholly owned subsidiaries of First Security Corporation, a bank holding company which is publicly owned. During the years in issue Utah Bank had 141,000 to 192,000 depositors and $217,000,000 to $292,000,000 in deposits and Idaho Bank had 118,000 to 131,000 depositors and $183,000,000 to $205,000,000 in deposits. Management Company provided accounting and other managerial services to subsidiaries of Holding Company.

Since 1948 the banks have made available to their borrowers credit life, health, and accident insurance which pays off the debt in case the borrower dies or is incapacitated during the term of his loan. The Tax Court found that they did this "for several reasons, including (1) to offer a service increasingly supplied by competing financial institutions, (2) to obtain the benefits of the additional collateral which credit insurance provides by repaying loans upon the death, injury, or illness of the borrower, and (3) to provide an additional source of income—part of the premiums for the insurance—to Holding Company or its subsidiaries." The premium charge for the credit insurance was at the uniform rate of $1.00 per $100.00 of coverage per year on a decreasing term basis. This was the rate commonly charged in the industry and was accepted by the insurance commissioners of the states involved—Utah, Idaho, and Texas. The banks did not require their borrowers to purchase credit insurance. During the taxable years less than 50% of their installment loan customers and less than 13% of their real estate loan customers elected to take insurance.

The banks had a routine procedure for making credit insurance available to customers. A loan officer explained the function and availability of the insurance. If the customer desired the insurance, the loan officer gave him the application forms for completion. Bank personnel examined the application, made out a certificate of insurance, and either collected the premium from the customer or added it to his loan. There is no showing that any of the bank personnel were licensed insurance agents. As the final step, bank employees forwarded the completed forms and premiums to Management Company for further handling.

Management Company's role in processing the credit insurance was in the nature of bookkeeping. It had no contact with the public in respect to the writing of credit insurance. It received the forms, duplicate certificates, and premiums from the banks, made records of the insurance purchased, and forwarded the premiums to the insurance carrier. It also did the paper work when claims were filed under the policies.

The following items show pertinent facts with regard to the credit insurance which concerns us.

1. The number of policies written and the amount of risk at the end of each year, 1954 to 1959, inclusive, varied from a low of 12,500 and $6,483,000 respectively in 1954 to a high of 36,416 and $41,350,000 respectively in 1959.

2. The net premiums for the years 1955 to 1959 inclusive totalled $1,916,241.95.

3. The claims and claim expenses for the years 1955 to 1959 inclusive totalled $525,787.91.

4. For the years in issue the total cost to the Utah Bank for processing the insurance was $8,929.30, to the Idaho Bank $9,826.43, and to Management Company $10,150.34. The Tax Court described these costs as "negligible."

From 1948 to April 1, 1954, the credit insurance coverage on the banks' borrowers was carried first by Credit Life Insurance Company of Springfield, Ohio, and later by American Bankers Life Assurance Company of Florida, both of which were independent of Holding Company and its subsidiaries. Commissions varying from 40% to 55% of net premiums were paid to Ed. D. Smith & Sons which was an insurance agency and a wholly owned subsidiary of Holding Company.

American National Insurance Company of Galveston, Texas, an independent company, wrote a large volume of credit insurance. Foreseeing a change in the credit insurance business, National, late in 1953, approached Holding Company and other financial institutions with a plan whereby it would write credit insurance available to borrowers. The plan called for Holding Company to create a life insurance subsidiary. The subsidiary's business would be to reinsure the risks of the credit insurance policies written by National for the customers of Utah Bank and Idaho Bank. Profits from the business could be retained in the subsidiary for investment. In its initial years, the subsidiary would utilize National's established and experienced operating services, such as actuarial and accounting, on a fee basis. If the plan proved successful, the new subsidiary could grow into a full-line, direct-writing insurance company.

Holding Company adopted National's plan and in June, 1954, incorporated First Security Life Insurance Company of Texas under the laws of Texas with an initial capital of $25,000 and an initial paid-in surplus of $12,500. The credit insurance written by National for the two banks was reinsured with Security Life under contracts called reinsurance treaties. Thereunder National received approximately 15% of the premium dollar for its technical services and Security Life received the balance for its assumption of 100% of the risks under the policies. The maximum risk on one life under the policies reinsured by Security Life was $5,000.

In 1956, Security Life's capital was increased to $100,000. During the period it did not become a full-line, direct-writing insurance company. Although Security Life's business proved successful, this result was not assured at the outset. In relation to its capital

structure Security Life reinsured a large amount of risk. As noted by the Tax Court, several aspects of its business could have invited high mortality rates. Customers of the banks obtained credit insurance without a health examination and without a waiting period. Also, Security Life was a relatively small insurance company and its policyholders lived in a relatively limited geographical area.

During the years in issue, Security Life paid state and federal taxes, used its own stationery, made deposits and withdrawals from bank accounts in its own name, and reinvested in its own name. Its sole source of business income was from reinsurance premiums. Its business expenses were primarily bank charges, taxes, and claims settlements. It paid a dividend to Holding Company of $389,821.61 in 1959.

On September 15, 1959, as a result of a reorganization pursuant to the 1956 act regulating bank holding companies, see 12 U.S.C. § 1841 et seq., the Utah and Idaho banks became owned by First Security Corporation, a publicly held corporation, and Security Life became owned by First Security Investment Company, also a publicly held corporation. The parties have stipulated that as of February, 1967, there was a substantial difference in the ownership of the shares of the two companies.

On December 21, 1962, the Commissioner sent notices of deficiency to the taxpayers based on an allocation to the banks of approximately 47% of Security Life's premium income, during the years in issue, after payment of National's management fees. An alternative allocation was made to Management Company. On the authority of *Local Finance Corporation v. Commissioner of Internal Revenue,* 48 T.C. 773, affirmed, 7 Cir., 407 F. 2d 629, cert. denied 396 U.S. 956, the Tax Court upheld Commissioner's allocation

of income to the banks and denied his alternative allocation to Management Company. The banks have each appealed from the adverse decision on liability for tax deficiencies, and the Commissioner has taken a protective appeal from the conclusion of no deficiency due from Management Company.

Section 61 of the Internal Revenue Code of 1954, 26 U.S.C. § 61, defines gross income to mean all income from whatever source derived including, among specified items, "(1) Compensation for services, including fees, commissions, and similar items; (2) Gross income derived from business."

Section 482 of the Code, 26 U.S.C. § 482, covers allocations of income and deductions among taxpayers and provides that:

> In any case of two or more organizations * * * owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, * * * if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, * * *.

In *Likins-Foster Honolulu Corp.* v. *Commissioner of Internal Revenue,* 10 Cir., 417 F. 2d 285, 292, cert. denied 397 U.S. 987, we recognized the purpose and effect of § 482, and the regulations thereunder. Treasury Regulations on Income Tax (1954), 26 C.F.R. § 1.482-1(b) and (c), provide that the standard to be applied in every case of a § 482 allocation "is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer" and that:

> The authority to determine the true taxable income extends to any case in which either by inadvertence or design the taxable income, in

> whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

During the tax years in question Utah Bank, Idaho Bank, Management Company, and Security Life were all wholly owned subsidiaries of Holding Company and under its control. We are concerned with allocation of income from Security Life to the two banks. That income consists of a portion of Security Life's share of premiums paid by borrowers from the banks and received by Security Life under its reinsurance treaties. The test to be applied is whether the banks' income with respect to the borrowers' purchase of credit insurance was other than it would have been had the banks in the conduct of their affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. *Davis* v. *United States*, 10 Cir., 282 F. 2d 623, 626. Application of that test to the facts presented is not easy.

The two banks are national banks. Section 92, 12 U.S.C., authorizes national banks located in a place having a population not to exceed 5,000 inhabitants to act as an insurance agent. In 1963, an administrative ruling by the Comptroller of the Currency purportedly authorized every national bank, regardless of where located, to enter the insurance agency field. That ruling was nullified by *Georgia Association of Independent Insurance Agents, Inc.* v. *Saxon*, N.D. Ga., 268 F. Supp. 236, affirmed 5 Cir., 399 F. 2d 1010, on the ground that, although § 92 does not explicitly prohibit banks in places with a population of over 5,000 from acting as insurance agents, it does so impliedly. In a different factual situation the Fourth Circuit held that a national bank is prohibited from

operating an insurance department except in towns of less than 5,000 inhabitants. See *Commissioner of Internal Revenue v. Morris Trust*, 4 Cir., 367 F. 2d 794, 795. We agree.

Section 93, 12 U.S.C., provides that for any violation of the chapter on national banks, the franchise of the banking association shall be forfeited and the directors individually shall be liable for damages sustained. The Tax Court found that because of the statutory provisions, and the advice of counsel relating thereto, the banks believed that it would be contrary to federal banking law to receive income resulting from their customers' purchase of credit insurance and they have never received commissions or reinsurance premiums arising from credit insurance transactions.

The Commissioner argues that the inhibitions of the banking laws do not preclude the operation of the tax laws. The banks concede the supremacy of the federal tax laws. Their position is that because of the prohibitions of the federal banking laws the banks have consciously remained aloof from any entitlement to income from the sale of insurance.

For the six years after the banks began offering credit insurance and before the formation of Security Life, the banks dealt exclusively with unrelated insurance companies in an uncontrolled situation. The Tax Court found that in the conduct of their affairs with these insurance companies the banks "never received or attempted to receive commissions or reinsurance premiums resulting from their customers' purchase of credit insurance." Conversely the Tax Court made no finding that if Security Life did not exist the banks would then receive or attempt to receive any such income. In an uncontrolled situation with arm's length dealing the banks, on the basis of

the findings made, would not have taxable income from the credit insurance transactions.

When all the underbrush is cut away, the theory of the Commissioner appears as a claim that the generation of the credit insurance business by the banks sustains the allocation of a portion of the premium income to them. He relies on *Local Finance Corporation* v. *Commissioner of Internal Revenue, supra.* We turn to that decision.

Local Finance presents a fact situation quite comparable to that confronting us. Commonly owned Indiana small loan companies offered credit insurance to their borrowers and about 90% of those borrowers took the insurance at the rate of $1.00 per year per $100 of coverage. For a part of the period the insurer paid a guaranteed commission of 40% of the net premiums, plus certain extras, to an officer of the finance companies who, upon receipt, assigned the amount to the parent company. Later, a controlled life insurance company was organized and it reinsured the risks. Indiana law forbade finance companies from receiving any income other than interest on loans. Each finance office had a licensed insurance agent. The Commissioner allocated a portion of both the commission income and the reinsurance income to the parent. The rationale of the Tax Court opinion in Local Finance is not clear. We believe that dissenting Judge Fay's analysis is correct. He said, 48 T.C. 773 at 802:

> The majority opinion also relies upon section 482 for support in allocating the income to petitioners in order to clearly reflect income. The premise of this approach is the previously reached conclusion that petitioners have earned the income by the performance of various serv-

> ices and have exercised a power of disposition over this income to channel it to the reinsurance company.

In affirming the Tax Court, the Seventh Circuit said, 407 F. 2d 629 at 632 and 633:

> The commissioner's allocation had the effect of compensating the finance companies for their efforts in generating and processing the life insurance.
>
> * * * * *
>
> However little the finance companies did to earn this money, they performed those minimal services which were the *sine qua non* of the insurance business.

The Commissioner now urges on us the generation of business theory. He says in his brief that "the effect of the Commissioner's allocation is to compensate Utah Bank and Idaho Bank for their efforts in generating and processing the credit insurance."

Generation of income differs from assignment of income. It is fundamental that a taxpayer cannot assign a portion of his income in order to avoid tax liability on it. See *Lucas* v. *Earl,* 281 U.S. 111. Also the power to dispose of income is the equivalent of ownership. *Helvering* v. *Horst,* 311 U.S. 112, 118. These principles are grounded on rights in or flowing from income. See *Poe* v. *Seaborn,* 282 U.S. 101, 117.

The position of the Commissioner in effect is that whoever generates income must include the amount thereof in his gross income. The fallacy of this position was exposed by the Tax Court in *Teschner* v. *Commissioner of Internal Revenue,* 38 T.C. 1003, 1007, when it said:

> If this were the law, agents, conduits, fiduciaries, and others in a similar capacity would be personally taxable on the proceeds of their efforts. The charity fund-raiser would be tax-

> able on sums contributed as the result of his efforts. The employee would be taxable on income generated for his employer by his efforts. Such results, completely at variance with every accepted concept of Federal income taxation, demonstrate the fallacy of the premise.

See also *Basye* v. *United States,* N.D. Calif., 295 F. Supp. 1289, 1292–1295.

Indeed, the acceptance of the generation of business theory would have alarming consequences on normal commercial practices such as all types of referral business and security commission giveups. See *Seieroe* and *Gerber,* "Section 482—Still Growing at the Age of 50," 46 Taxes 893, 900–902 (Dec. 1968). We believe that in principle it runs contrary to all court and Tax Court decisions except Local Finance.

From the standpoint of principle the case at bar is indistinguishable from such cases as *Nichols Loan Corporation of Terre Haute* v. *Commissioner of Internal Revenue,* 21 T.C.M. 805, reversed on other grounds, 7 Cir., 321 F. 2d 905 (deduction by small loan companies of expenses attributable to credit insurance); *Campbell County State Bank, Inc., of Herreid, South Dakota* v. *Commissioner of Internal Revenue,* 37 T.C. 430, reversed on other grounds, 8 Cir., 311 F. 2d 374 (attribution of income and expenses of commonly owned insurance agency to bank); *L. E. Shunk Latex Products, Inc.* v. *Commissioner of Internal Revenue,* 18 T.C. 940 (allocation to manufacturer of part of income of controlled outlet when manufacturer was prohibited by maximum price regulations from receiving the income sought to be allocated); *Jaeger Motor Car Company* v. *Commissioner of Internal Revenue,* 17 T.C.M. 1098, 7 Cir., 284 F. 2d 127, cert. denied 365 U.S. 860 (anticipatory transfer of insurance income from agent to controlled company); *Moke Epstein,*

Inc. v. *Commissioner of Internal Revenue*, 29 T.C. 1005 (insurance commissions received by president of taxpayer); and *Ray Waits Motors, Inc.* v. *United States*, E.D. S.Car., 145 F. Supp. 269 (insurance commissions received by president of taxpayer).

Even though the credit insurance emanated from the banks in connection with their loan business, the result does not follow that the banks should be taxed for income which they neither earned nor received. They did not earn it because (1) they were not licensed insurance agents, (2) they were impliedly prohibited by federal law from operating an insurance business, (3) their participation required minimal effort and negligible cost compatible with the added protection which they secured for loan payment, and (4) they had no underwriting risk. True it is that they physically received the premium payments but in so doing they acted only as a conduit to pass them on intact to others who were legally entitled thereto.

Consideration of §§ 61 and 482 separately or in tandem does not change the result. The § 61 cases such as *Lucas* v. *Earl, supra,* and *Helvering* v. *Horst, supra,* are not pertinent because the banks neither assigned nor otherwise disposed of income. They simply had no income from the credit insurance business. We are unwilling to extend those decisions to situations where the taxpayer has the power to channel profitable business.

The test for allocations under § 482 is arm's length dealing with an uncontrolled taxpayer. As the Tax Court recognized, in arm's length dealings with independent insurers before the organization of Security Life the banks did not receive income from credit insurance premiums. In our opinion the change to the reinsurance arrangement with National and Secu-

rity Life did not change the situation so far as the income of the banks is concerned. They handled the business in the same way and were under the same inhibitions. The change in operations was for the benefit of Holding Company, not the banks.

We recognize the established rules that substance prevails over form, that the Commissioner has a wide discretion which we may not upset unless it is used arbitrarily or capriciously, and that the burden of persuasion lies on the taxpayers. These do not change the result. Generation of business is not enough to impose federal income tax liability. The effect of the action of the Commissioner and the decision of the Tax Court is to allocate approximately $800,000 in income to the banks and charge them with nearly $400,000 in tax deficiencies thereon. The banks have not received, and in all probability never can receive, the income because of the present diverse public ownership of the parent of the banks and the parent of Security Life. We believe that the § 482 allocations made by the Commissioner are arbitrary and capricious and inconsonant with the basic concepts of federal income taxation. To the extent that this opinion is inconsistent with that in Local Finance we respectfully disagree with that decision.

Because it upheld the Commissioner's allocations of income to the banks, the Tax Court rejected his alternative allocation to Management Company. Counsel for the Commissioner say that there is an adequate basis for the alternative allocation but we cannot answer that question on the record presented. It must be considered in the first instance by the Tax Court.

In Nos. 611–69 and 612–69 the judgments are severally reversed. In No. 613–69 the judgment is reversed and the case is remanded to the Tax Court for further consideration.

APPENDIX C

No. 611–69

FIRST SECURITY BANK OF UTAH, N.A., PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLEE

No. 612–69

FIRST SECURITY BANK OF IDAHO, N.A., PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLEE

No. 613–69

FIRST SECURITY COMPANY, PETITIONER-APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLANT

Before Honorable Jean S. Breitenstein and Honorable Oliver Seth, Circuit Judges; and Honorable George Templar, District Judge.

January Term—January 21, 1971

These consolidated cases came on to be heard on the petitions for review from the United States Tax Court and were argued by counsel. On consideration whereof, it is ordered as follows:

1. In Cases Nos. 611–69 and 612–69 the decisions of the Tax Court are severally reversed.

2. In Case No. 613–69, the decision of the Tax Court is reversed and the case is remanded to the Tax Court for further consideration.

HOWARD K. PHILLIPS,
Clerk.

By HELEN R. BARTHA,
Deputy Clerk.

A true copy.
Teste.
Howard K. Phillips,
Clerk, U.S. Court of Appeals, Tenth Circuit.
By Helen R. Bartha,
Deputy Clerk.

APPENDIX D

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.* Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

* * * * *

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

Treasury Regulations on Income Tax (26 C.F.R.):

Sec. 1.482-1. *Allocation of income and deductions among taxpayers.*

(a) *Definitions.* When used in this section * * *

* * * * *

(6) The term "true taxable income" means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.*—

(1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied

in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

* * * * *

(c) *Application.*—Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

* * * * *

Revised Statutes:

SEC. 5202 [as amended by Section 1, Act of September 7, 1916, c. 461, 39 Stat. 752]. * * *

* * * * *

That in addition to the powers now vested by law in national banking associations organized under the laws of the United States any such association located and doing business in any place the population of which does not exceed five thousand inhabitants, as shown by the last preceding decennial census, may, under such rules and regulations as may be prescribed by the Comptroller of the Currency, act as the agent for any fire, life, or other insurance company authorized by the authorities of the State in

which said bank is located to do business in said State, by soliciting and selling insurance and collecting premiums on policies issued by such company; and may receive for services so rendered such fees or commissions as may be agreed upon between the said association and the insurance company for which it may act as agent; and may also act as the broker or agent for others in making or procuring loans on real estate located within one hundred miles of the place in which said bank may be located, receiving for such services a reasonable fee or commission: *Provided, however,* That no such bank shall in any case guarantee either the principal or interest of any such loans or assume or guarantee the payment of any premium on insurance policies issued through its agency by its principal: *And provided further,* That the bank shall not guarantee the truth of any statement made by an assured in filing his application for insurance.

[12 U.S.C. (1946 ed.) 92.]*

SEC. 5239.

If the directors of any national banking association shall knowingly violate, or knowingly permit any of the officers, agents, or servants of the association to violate any of the provisions of this Title all the rights, privileges, and franchises of the association shall be thereby forfeited. Such violation shall, however, be de-

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*Because this provision was omitted from the 1918 amendment and reenactment of Section 5202 of the Revised Statutes by Section 20 of War Finance Corporation Act, c. 45, 40 Stat. 506, 512, the revisers of the United States Code have omitted it from editions of the Code, subsequent to the 1946 edition, on the theory that it was repealed in 1918. The implicit statutory proscription is, however, incorporated in the Comptroller of the Currency's current Regulations as 12 C.F.R. 2.1–2.5. See *Commissioner* v. *Morris Trust*, 367 F. 2d 794, 795 & n. 3 (C.A. 4); *Saxon* v. *Georgia Ass'n of Independent Ins. Agents*, 399 F. 2d 1010 (C.A. 5).

termined and ajudged by a proper district or Territorial court of the United States in a suit brought for that purpose by the Comptroller of the Currency, in his own name, before the association shall be declared dissolved. And in cases of such violation, every director who participated in or assented to the same shall be held liable in his personal and individual capacity for all damages which the association, its shareholders, or any other person, shall have sustained in consequence of such violation.
[12 U.S.C. 93.]

U.S. GOVERNMENT PRINTING OFFICE: 1971